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No. 21

In the Supreme Court of the United States

OCTOBER TERM, 1956

BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION, PETITIONER

v.

GILBERT PARNELL, RESPONDENT

On Writs of Certiorari to the United States Court of Appeals for the Third Circuit

BRIEF FOR RESPONDENT

EDWARD DUMBAULD,
52 East Main Street,
Uniontown, Pennsylvania
Attorney for Respondent

INDEX

	Page
Opinions Below	1
Jurisdiction	1
Questions Presented	2
Statutes Involved	2
Statement	2
Summary of Argument	8
Argument	
I. Federal law governs the process of transmitting government bonds through the Federal Reserve System for collection and redemption	**15**
II. A "conduit" or intermediary in the process of transmitting government bearer bonds for redemption in good faith and in strict accordance with treasury regulations is not liable for conversion of the bonds handled	**38**
III. Government bonds, redeemable but not yet due and payable, are not overdue paper	**47**
Conclusion	57
Appendix	60

CASES

Page

Carpenter v. Shaw, 280 U. S. 363 (1930) 26

Clearfield Trust Co. v. U. S.,
318 U. S. 363 (1943) 8, 16-20, 21, 23, 25, 26, 29-32, 57

County of Presidio v. Noel-Young Bond &
Stock Co., 212 U. S. 58 (1909) 14, 43, 57

Davies Warehouse Co. v. Bowles, 321 U. S. 144 (1944) 22

Deitrick v. Greaney, 309 U. S. 190 (1940) 9, 27, 30

D'Oench, Duhme & Co. v. F. D. I. C.,
315 U. S. 447 (1942) 9, 27, 30

De Sylva v. Ballentine, 351 U. S. 570 (1956) 23

Erie R. R. Co. v. Tompkins,
304 U. S. 64 (1938) 8, 10, 16, 20, 25, 31, 57

First National Bank v. Goldberg, 340 Pa. 337 (1941) 13, 43

Floyd Acceptances, 7 Wall. 666 (1868) 19

Francis v. Southern Pacific Co.,
333 U. S. 445 (1948) 9, 24-25

Garrett v. Moore-McCormack Co., 317 U. S. 239 (1942) 26

Gibbons v. Ogden, 9 Wheat. 1 (1824) 9, 25

Graham v. White-Phillips Co., 296 U. S. 27 (1935) 38, 43

Gruntal v. U. S. F. & G. Co., 254 N. Y. 468 (1930) 13, 15, 43

Guaranty Trust Co. v. York, 326 U. S. 99 (1945) 32

Guldager v. U. S., 204 F. 2d 487, (C. A. 6, 1953) 34

Hannum v. Amsterdam Casualty Co., 330 Pa. 353 (1938) 26

Heiser v. Woodruff, 327 U. S. 726 (1946) 24

Hinderlider v. LaPlata River & Cherry Creek
Ditch Co., 308 U. S. 92 (1938) 9, 31

Hotchkiss v. Banks, 88 U. S. 354 (1874) 43

Hutchinson Investment Co. v. Caldwell,
152 U. S. 65 (1894) 23

CASES

Page

Jackson County v. U. S., 308 U. S. 343 (1939) 26

Kansas City Southern Ry. Co. v. Van Zant, 260 U. S. 459 (1923) 26

Kimball v. Billings, 55 Me. 147 (1867) 43

Kneeland v. Lawrence, 140 U. S. 209 (1891) 43

Morgan v. U. S., 113 U. S. 476 (1885) 13, 43, 49, 50-53, 54, 56

Murray v. Lardner, 2 Wall. 110 (1864) 12, 41-43

National Metropolitan Bank v. U. S., 323 U. S. 454 (1945) 20

Poff v. Penna. R. R. Co., 327 U. S. 399 (1946) 23

Pope & Talbot v. Hawn, 346 U. S. 406 (1953) 26

Pratt v. Higginson, 230 Mass. 256 (1918) 13, 43

Priebe & Sons, Inc., v. U. S., 332 U. S. 407 (1947) 26

Ry. Co. v. Sprague, 103 U. S. 756 (1880) 14, 43, 57

R. F. C. v. Beaver County, 328 U. S. 204 (1946) 23

Royal Indemnity Co. v. U. S., 313 U. S. 289 (1941) 26

Smith v. Harlow, 64 Me. 510 (1874) 43

Smyth v. U. S., 302 U. S. 329 (1937) 13, 53-56

Southern Pacific Co. v. Arizona, 325 U. S. 761 (1945) 9, 22

Steele v. L. & N. R. R. Co., 323 U. S. 192 (1944) 23

Texas v. White, 7 Wall. 700 (1868) 42, 48-50

U. S. v. Ansonia Brass and Copper Co., 218 U. S. 452 (1910) 26

U. S. v. County of Allegheny, 322 U. S. 177 (1944) 23

U. S. v. Dauphin Deposit Trust Co., 50 F. Supp. 73 (M. D. Pa. 1943) 34

U. S. v. Fullard-Leo, 331 U. S. 256 (1947) 26

U. S. v. Janowitz, 257 U. S. 42 (1921) 34

CASES

	Page
U. S. v. Matthews, 139 F. Supp. 683 (N. D. Calif N. D. 1956)	22
U. S. v. Sacks, 257 U. S. 37 (1921)	34
U. S. v. Standard Oil Co., 332 U. S. 301 (1947)	9, 28-30
U. S. v. Standard Rice Co., 323 U. S. 106 (1944)	26
Utah Power & Light Co. v. U. S., 243 U. S. 389 (1917)	26
Vermilye Co. v. Adams Express Co., 21 Wall. 138 (1874)	50

STATUTES

	Page
Conformity Act, 28 U. S. C. 1652	32
Home Owners' Loan Act, 12 U. S. C. 1463 (c)	15

GENERAL

	Page
Brant, James Madison, III, 290 (1950)	19
Britton, Bills and Notes (1943) 1035	45
Chafee, "Rights in Overdue Paper," 31 Harv. L. R. 1104, 1126 (1918)	56
Restatement, Agency, sec. 349, comment g, and Torts, sec. 233, subsection 4	13, 43, 44
Shriver, Holmes Book Notices and Uncollected Papers (1936) 90-92	46
Warren, Trover and Conversion (1936) 90-92	44

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OPINIONS BELOW

The (R. 44 of App

The memorandum opinion of the District Court (R. 445) is unreported. The opinion of the Court of Appeals (R. 496) is reported at 226 F. 2d 297.

JURISDICTION

The tered o certiora granted diction 1254 (1 fore or materia ment of new tria locutory

The judgment of the Court of Appeals was entered on October 14, 1955 (R. 518). Petition for certiorari was filed December 20, 1955 and was granted February 27, 1956 (R. 519). The jurisdiction of this Court is invoked under 28 U. S. C. 1254 (1). As this section authorizes review "before or after rendition of judgment" it is immaterial that as to respondent Parnell the judgment of the Court of Appeals, directing that a new trial be granted, might be regarded as interlocutory.

QUESTIONS PRESENTED

1. Does federal law (under *"Clearfield"* principles, rather than State law under *"Erie"* doctrine) govern the process of transmitting government bonds through the Federal Reserve System for collection and redemption?

2. Can parties who serve only as "conduits" or intermediaries in the collection process and who act in strict accordance with Treasury Regulations be held liable, in the absence of proof of bad faith or actual notice of any irregularity, for conversion of bearer bonds handled by them?

3. Does the fact that inoperative coupons are attached to a government bearer bond which is redeemable but not yet due and payable require that the preceding question be answered any differently?

STATUTES INVOLVED

Pertinent provisions of the Home Owners' Loan Act of June 13, 1933, 48 Stat. 129 as amended by the Act of April 27, 1934, 48 Stat. 643 (12 U. S. C. A. 1463(c)) and of applicable Treasury Regulations are set forth in the Appendix hereto, p. 60 *infra*.

STATEMENT

Petitioner, a national banking association having its principal place of business in San Fran-

cisco, brought suit in the United States District Court for the Western District of Pennsylvania against four defendants, alleging that each of them converted to his or its own use two batches of Home Owners' Loan Corporation 3% Series A bearer bonds (R. 12-15, 28).

The Home Owners' Loan Corporation is an instrumentality of the Federal Government, and the bonds, as required by law, stated on their face that they were fully and unconditionally guaranteed both as to interest and principal by the United States.

The bonds were bearer bonds, as stated on their face. The interest coupons were also payable to bearer, as a separately stated obligation.

Principal and interest were made payable "at the Treasury Department, Washington, D. C., or at any government agency or agencies in the United States which the Secretary of the Treasury may from time to time designate for the purpose."

The bonds were stated to be "payable May 1, 1952." However, they were redeemable upon call on any interest date on or after May 1, 1944, and interest thereafter was to be discontinued, whether or not the bond and accompanying coupons were surrendered. The bonds were tax exempt. (R. 449-452).

pondent Gilbert S. Parnell is senior partR a country law firm engaged in general pracner t Indiana, Pennsylvania (R. 301-2). The tice of one Arthur Rocco had been clients of fam m for a long time, and in September of 1948 the consulted Parnell regarding establishment Ro istributorship for the then much publicized of r automobile. For this venture, as well as Tu oal stripping operations, Rocco stated that he hed to turn some bonds into cash, and reso d Parnell to handle the transaction at the he National Bank in Indiana, of which Parnell qu director (R. 303-4).

Fi September 28, 1948, Parnell took to the wa the first batch of Home Owners' Loan Cor- on bonds involved in this suit, amounting Ba 600.00. On the same day the Bank forpo l the bonds by registered mail to the Pittsto Branch of the Federal Reserve Bank of wa nd. The Federal Reserve Bank of Clevebu hich was a fiscal agent of the United States Cl purpose of paying such bonds, credited la ount to the First National Bank of Info ith Treasury regulations. On October 1, th he First National Bank of Indiana issued di nell a cashier's check for the amount colar (less $10.00 expenses). Parnell cashed the 19 nd turned the money over to Rocco.* (R. to-

le the proceeds of the three batches of bonds Parnell was l fees, amounting to $650 as he recalls. (R. 317). Acb Rocco it was a larger amount. (R. 491-92).

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16-21, 158-64, 297, 304-7, 314-16, 340-41). The money received by Parnell was in bills of $100.00 and smaller; the Bank did not carry any larger bills on hand. (R. 344).

On October 25, 1948, the second batch of Home Owners' Loan Corporation bonds, amounting to $38,000.00, was similarly received by Parnell from Rocco, turned over to the First National Bank in Indiana for collection, forwarded by it to the Federal Reserve Bank of Cleveland for redemption, and the proceeds credited to the First National Bank in Indiana, which on October 28, 1948, issued its check to Parnell (deducting $20.00 expenses), and Parnell cashed the check and turned over currency in small denominations to his client (R. 17-18, 22-24, 165-68, 317-19, 341).

Earlier in September there had been another similar transaction, dealing with securities not involved in this case ($20,000 West Penn Power bonds and $5,000 Treasury bonds). Some time after the transactions involved in this suit, the First National Bank in Indiana first got word of any irregularities in connection with bonds received from Parnell to be collected for Rocco. That notice related to the Treasury and West Penn Power bonds not involved in this case. The bank notified Parnell. (R. 308, 345, 348, 353, 485-

87).* This investigation led to indictment of Rocco on March 25, 1949, and his subsequent conviction on December 5, 1950, for interstate transportation of stolen property. Subsequently, on January 26, 1951, the Bank in Indiana received notice from petitioner's counsel regarding the Home Owners' Loan Corporation bonds involved in the present suit (R. 324, 370).

At the time the transactions occurred, neither the First National Bank in Indiana (R. 324, 341-42) nor Parnell (R. 307-8) had notice of any irregularities with respect to any bonds received from Rocco. The Bank did know that the Home Owners' Loan bonds had been called for redemption (R. 355). Parnell did not (R. 312-13).

Considerable testimony was adduced at the trial regarding the circumstances under which the Home Owners' Loan bonds involved in this case disappeared under mysterious circumstances from

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* According to Parnell's recollection, and that of the cashier of the Bank, the discussions of the matter with Parnell at the Bank took place in January or February of 1949. (R. 308, 353, 485). However, the date may have been somewhat earlier. Myers, an F. B. I. agent, testified that on November 5, 1948, he called on Parnell regarding the $5000 of Treasury bonds (R. 372, 375). Parnell could not remember the date of the agent's visit (R. 487). The cashier testified that the Bank's first knowledge came through the F. B. I. and that the first call was not regarding the Home Owners' Loan bonds involved here (R. 345-46). Agent Myers said that he first called at the Bank regarding the Home Owners' Loan bonds on January 14, 1949 (R. 381). In any event, the notice was received after the completion of the transactions involved in this case.

petitioner's banking house in San Francisco on May 2, 1944, while an employee was preparing them to be forwarded to the Federal Reserve Bank for redemption (R. 59-62, 32-91). As proof of the widespread "hue and cry" raised by petitioner following this loss,* evidence was received of notice sent to the Federal Reserve Bank of Cleveland (R. 100-104) and of the fact that the Pittsburgh office of the F. B. I. advised the Los Angeles office on May 22, 1944, that a circular had been mailed to all banks and brokers in the Pittsburgh district. There was "no specific evidence in the file relating to the mailing to the First National Bank in Indiana, Pennsylvania." (R. 241). This circular was not admitted against Parnell (R. 244-49).

Petitioner's complaint was filed February 15, 1951, against four defendants: Rocco, Parnell, First National Bank in Indiana, and the Federal Reserve Bank of Cleveland. The trial court dismissed the Federal Reserve Bank (R. 413). Rocco did not appeal. The Court of Appeals, reversing the District Court, directed that judgment be entered for the First National Bank in Indiana (R. 517) and that a new trial be granted Parnell (R. 518).

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* These documents were not offered as proof of actual notice to any of the defendants, except possibly the addressee, the Federal Reserve Bank of Cleveland (R. 104, 144). They were not offered as against Parnell (R. 138). However, Exhibit 12 was admitted generally (R. 136, 142, 148). See also R. 94, 97.

SUMMARY OF ARGUMENT

I

The process of transmitting government bearer bonds for redemption through the Federal Reserve System in accordance with Treasury Regulations is a federal subject matter governed by federal law. *Clearfield Trust Co.* v. *U. S.*, 318 U. S. 363 (1943), exemplifies the principle applicable here, rather than the rule of *Erie R. R. Co.* v. *Tompkins*, 302 U. S. 64 (1938), calling for application of State law.

The principle of federal law to govern federal subject matter where uniformity is desirable is recognized in many fields, in addition to the situation in *Clearfield* where the United States was suing on its own commercial paper. *Clearfield* is not an unusual or undesirable phenomenon which should be restricted to its particular facts and limited to situations where the Government is a party litigant.

To say that the doctrine of federal law for federal subject matter is merely a device to give the Government an advantage over private parties in lawsuits is to malign the important function of this Court as balance wheel in our dual system of government. Sometimes application of federal law is advantageous to the Government, sometimes it is not. In any event that factor is not

the reason which impels this Court to apply federal rather than State law.

The controlling considerations of public interest with respect to this issue are similar to the familiar problem of determining whether uniformity is desirable in the regulation of interstate commerce. *Southern Pacific* v. *Arizona,* 325 U. S. 761, 767 (1945).

Petitioner's claim that a tort action for conversion is a State-created proceeding necessarily governed by State law is disproved by consideration of *Francis* v. *Southern Pacific Co.,* 333 U. S. 445 (1948), and, indeed, by principles well-known since *Gibbons* v. *Ogden,* 9 Wheat. 1 (1824).

Illustrations of various fields where the principle of federal law for federal subject matter as to which uniformity is desirable is applied include railway labor legislation, interstate commerce, bankruptcy, procurement contracts, public lands, Indian affairs, banking, utilization of interstate streams, and the status of soldiers. A particularly enlightening discussion of the subject is found in *U. S.* v. *Standard Oil Co.,* 332 U. S. 301 (1947). Other leading cases are *D'Oench, Duhme & Co.* v. *F. D. I. C.,* 315 U. S. 447 (1942); and *Deitrick* v. *Greaney,* 309 U. S. 190 (1940). The coexistence of federal law with *Erie* doctrine is shown by the fact that *Hinderlider* v. *La Plata River & Cherry Creek Ditch Co.,* 308 U. S. 92

(1938), applying federal law to problems arising from apportionment of water in an interstate stream, was decided on the same day as *Erie* and the opinion was likewise by Mr. Justice Brandeis.

Application of federal law in the case at bar is necessary for protection of the Government's discretionary power to fashion the public debt structure. It is also vital to the interest of the financial community.

The distinctive features of government bearer bonds would be obliterated if States could regulate transfer of such securities, or if recourse to State law were needful to appraise the validity of such transfers. A record of the route traveled by each bond, and of the date and place of each transaction affecting title to it, would be necessary for the safety of parties dealing with the bond. This would transform the nature of the instruments themselves. Instead of being freely negotiable bearer bonds the Government would in practice be confined to issuance of securities having the characteristics of registered or non-transferable bonds. This would encroach upon the Government's freedom of choice in shaping the public debt structure.

Moreover, since the value of bonds to the original purchaser is dependent upon their free negotiability and the ability of subsequent parties to engage safely in dealings with respect to such

bonds, the value of bonds to the first purchaser and hence their salability by the Government would be materially affected. The advantages of government bearer bonds as a safe and convenient medium of investment for liquid capital, with a flexibility practically equivalent to cash, would also be destroyed.

Vital public interests, both of the financial community and of the Government, require application of federal law to the subject matter involved in the case at bar.

The Congress, and the Secretary of the Treasury through regulations having the force of law, have determined that these bonds should be issued in bearer form and that they should be transferable by delivery. The legal consequence of such determination is not merely that the bonds may be discharged by payment to the person presenting them (indeed that subject is separately covered elsewhere in the Regulations) but also that in transactions in the market place between other parties *inter sese* the bonds may safely be dealt with as bearer securities which can be transferred freely like currency or negotiable instruments; and hence that a "conduit" bank serving as intermediary in the collection process is relieved of liability for conversion.

II

A bank acting as a mere "conduit" or intermediary in the process of transmitting govern-

ment bearer bonds, in strict accord with Treasury Regulations, through the channels of the Federal Reserve System for redemption, is not liable, in the absence of proof of bad faith, for conversion of the bonds handled.

Such a "conduit" bank is not required to prove that it is a "holder in due course." That concept would require proof that the bank took for value; and a "conduit" bank never gives value in the sense of investing its own funds in purchase of bonds handled.

It would be utterly irrational and impracticable to hold a bank which merely forwards bonds for redemption and disburses the proceeds collected to a higher standard of care and diligence than is required of a bank purchasing such bonds for investment. Reason and logic dictate that the investor should be held to a stricter standard than the mere instrumentality of commercial intercourse, if there is to be a distinction. A contrary rule would paralyze banking operations. A "conduit" bank is entitled to protection *a fortiori* in a situation where a purchasing bank would be relieved of liability for conversion of government bearer bonds.

The leading case in this Court is *Murray* v. *Lardner*, 2 Wall. 110 (1864). This case has been followed and cited as late as 1935. Important State courts have also accorded protection to

"conduit" parties who act in good faith. *Pratt* v. *Higginson,* 230 Mass. 256 (1918); *Gruntal* v. *U. S. F. & G. Co.,* 254 N. Y. 468 (1930); *First National Bank* v. *Goldberg,* 340 Pa. 337 (1941); Restatement, Agency, sec. 349, Torts, sec. 233.

III

Government bonds, redeemable but not yet due and payable, are not overdue paper. *Morgan* v. *U. S.,* 113 U. S. 476 (1885). Such bonds do not become *functus officio* or dishonored upon call; they merely cease to bear interest. A holder may well choose to retain his bond "as a continuing security for the value it always represents, having impressed upon it by the law of its creation the faculty of passing from hand to hand as money, and therefore just as useful in the pursuits of trade and the exchanges of commerce as so much money in the form of coin or bank notes, and more convenient because more portable." *Smyth* v. *U. S.,* 302 U. S. 329, 357 (1937), does not dilute, but confirms this holding.

Nor does the presence of inoperative interest coupons constitute constructive notice of any infirmity with respect to the principal of the bonds. The interest coupons are independent bearer obligations, separate from the bond to which they are attached. Even if the coupons were overdue (instead of being, as here, merely inoperative, by reason of the call), there would be no imputation

of notice of default or infirmity with respect to the principal of the bonds. *Ry. Co.* v. *Sprague*, 103 U. S. 756, 760-61 (1880); *County of Presidio* v. *Noel-Young Bond & Stock Co.*, 212 U. S. 58, 74-75 (1909).

The presence of inoperative coupons and the fact that the bonds were called was no proof of bad faith in the case at bar, either with respect to the First National Bank in Indiana, which had knowledge of the call, or with respect to Parnell, who did not.

These circumstances would not diminish the protection to which respondents would be entitled if the Court accepts the contentions in Points I and II *supra* with regard to the applicability of federal law and the non-liability of "conduit" parties for conversion of government bearer bonds handled.

ARGUMENT

I

Federal Law governs the process of transmitting Government Bonds through the Federal Reserve System for collection and redemption.

The main issue in this case is whether a bank or other party, acting merely as a "conduit"* or intermediary in the collection process when government** bonds payable to bearer are forwarded through the Federal Reserve System in accordance with Treasury Regulations for redemption, can be held liable for conversion of the bonds handled.

As the Court of Appeals pointed out (R. 497, 226 F. 2d at 299), the trial court considered the case at bar as "an ordinary, garden variety, diversity of citizenship case."

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* This expressive word is used in *Gruntal* v. *U. S. F. & G. Co.*, 254 N. Y. 468, 474 (1930) to describe parties in the position of respondents here.

** For brevity the Home Owners' Loan Corporation bonds involved in this case are called government bonds in this brief. They are "fully and unconditionally guaranteed both as to interest and principal by the United States." The primary obligor is "an instrumentality of the United States," created under an Act of Congress. All its stock is owned by the United States. "All redemptions, purchases, and sales by the Secretary of the Treasury of the bonds of the Corporation shall be treated as public-debt transactions of the United States." 12 U. S. C. A. 1463. Treasury Regulations and practice so treat them.

The trial judge* accordingly applied State law under the doctrine of *Erie Railroad Co.* v. *Tompkins*, 304 U. S. 64 (1938), and held that under the Negotiable Instruments Law of Pennsylvania the "conduit" bank had the burden of proving that it was a "holder in due course" of the bonds.** We contend, on the other hand, (and the Court of Appeals agrees), that this is a case in which the *Erie* rule must give way to the doctrine of federal law for federal subject-matter which was exemplified in *Clearfield Trust Co.* v. *U. S.*, 318 U. S. 363 (1943).

The *Clearfield* case, as the Court of Appeals well says, compels the conclusion that

> where United States bonds are concerned, we must look to federal law to determine not only the nature of the obligations, rights, and duties of the United States as a party, but also the rights and duties of holders and transferees of such bonds among each other. (R. 497, 226 F. 2d at 299).

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* Who took office on July 24, 1953 (204 F. 2d ix) and was assigned to this case on September 25, 1953 (R. 5).

** This would necessitate proving that it took for value. Since at the time of receiving the bond a "conduit" bank pays out nothing, and after it collects the proceeds it merely disburses the proceeds it has collected, it never gives value in the sense of investing its own funds in purchase of the bond. The entire concept of "holder in due course" is thus altogether inapplicable, in logic and reason, to the position of a "conduit" bank. The "federal rule" which will be discussed in Point II *infra* recognizes this. To treat the concept of "holder in due course" as controlling, as the dissent of Justice Goodrich would do, (R. 510-12, 226 F. 2d at 306-7) is simply to engage in a series of inapposite verbal manipulations.

The type of government obligation involved in the *Clearfield* case was not a bearer bond, but a check issued by the proper government official to pay a WPA worker. The check was cashed by an unauthorized person under a forged endorsement at a Penney store in connection with a sale of merchandise. The check was paid by the government upon presentation by a bank which guaranteed prior endorsements. The payee discovered and reported the forgery on November 30, 1936. No notice was given to the bank until January 12, 1937. When suit was brought by the government to obtain reimbursement under the bank's guarantee of all prior endorsements, the trial court dismissed the action on the basis of a rule of State law in Pennsylvania relieving the innocent endorser if the drawee fails to give immediate notice upon discovery of the forgery. This ruling was reversed. This Court held that State law did not apply to the subject matter under consideration. The Court said:

> The rights and duties of the United States on commercial paper which it issues are governed by federal rather than local law. When the United States disburses its funds or pays its debts, it is exercising a constitutional function or power. . . . The issuance of commercial paper by the United States is on a vast scale and transactions in that paper from issuance to payment will commonly occur in several states. The appli-

> cation of state law, even without the conflict of laws rules of the forum, would subject the rights and duties of the United States to exceptional uncertainty. It would lead to great diversity in results by making identical transactions subject to the vagaries of the laws of the several states. The desirability of a uniform rule is plain. (pp. 366-67).

While the facts involved in the *Clearfield* case related to the Government's rights on its own commercial paper, there is no warrant for limiting the applicability of the principle it exemplifies to cases where the United States is a party to the litigation. It should be noted that the Court emphasized "the desirability of a uniform rule." That is the basic criterion. The Court also pointed out that transactions in Government paper "*from issuance to payment* will commonly occur in several states" and that the application of State law to such transactions would lead to great diversity in results "by making identical transactions subject to the vagaries of the laws of the several States."

In the case of government bonds of the type involved here, similar transactions "*from issue to payment*" will likewise commonly occur in several States and would be subjected to the vagaries of State law unless "the desirability of a uniform rule" is recognized. Federal law should be ap-

plied to the transactions *"from issue to payment"* in which intermediate parties dealing with the bonds *inter sese* engage, even if the United States is not a party to the suit.

If the concept of federal law is applied to the *Clearfield* situation, it should *a fortiori* be applied to the situation involved in the case at bar. For the Government's power to become a party to commercial paper is not inherent but is purely the creature of statute. *The Floyd Acceptances,* 7 Wall. 666 (1868). But the power to borrow money is not only specifically embodied in the Constitution (Art. I, sec. 8, par. 2; Art. VI, par. 1), but was exercised, before adoption of that instrument, by the Continental Congress during the Revolutionary War. Our national independence is rooted upon exercise of the borrowing power. Alexander Hamilton's fame as a statesman rests upon his federal policy with respect to the public debt. His parting of the ways with James Madison was due to disagreement over the rights to be accorded as a matter of federal policy to *transferees* of the obligations evidencing public debt (in other words, the very subject matter which petitioner here contends is of no concern to the Government, because it involves only transactions affecting the rights of private parties *inter sese).* James Brant, *James Madison,* III, 290-95 (1950). It is unnecessary to say how important it is in the present era of "deficit financing" to maintain unimpaired the federal Government's complete

authority with respect to policy concerning types of securities to be issued and indeed every aspect of management of the public debt.

It would be wrong to suppose that since *Erie* the prevailing philosophy is that there is and should be no such thing as a federal common law, and that a decision such as *Clearfield* which recognizes the applicability of such a federal law is an exceptional and undesirable phenomenon, which should be curtailed and restricted in its application so far as possible, and that therefore *Clearfield* should be confined to its particular facts, and not extended to any situation where the Government itself is not a litigant.

On the contrary, examination of the cases discloses that in many fields involving federal subject matter where uniformity is desirable, federal law is applied. *Erie* did not stigmatize federal law as *filius nullius*. It is a legitimate and normal feature of the federal judicial process in numerous and diversified spheres of application.

National Metropolitan Bank v. *U. S.*, 323 U. S. 454, 456 (1945), differs from the *Clearfield* case in that the government checks there involved were procured to be issued by the fraud of a government employee through the use of forged travel vouchers. He added forged endorsements of the payees and his own endorsement, and cashed the checks at a bank. That bank guaranteed all prior

endorsements and forwarded the checks to the National Metropolitan Bank, which made a similar endorsement, as required by Treasury regulations, in order to obtain payment from the government. In this case the *Clearfield* rule was followed, and the Court held that legal questions involved in controversies over government commercial paper are to be solved by application of federal rather than State law.

Petitioner contends that the United States has no substantial interest in the outcome of litigation between private parties who deal in its bonds, and that the *Clearfield* rule should be limited to cases involving the legal consequences to be attributed to transactions in which the Government itself is a party. Since the application of State law in the *Clearfield* case would have made the legal rights of the United States dependent on the will of the States, petitioner says, a situation objectionable under our dual system of government would arise if federal law were not applied.

We submit that this is a serious misconception of the basis and scope of the *Clearfield* doctrine. The underlying principle of the *Clearfield* case is that federal law should govern where the subject matter of the litigation is federal in nature. The subject matter, not the identity of the parties to the case, is the determinative factor.

To say that this Court sits to spin out a doctrine of federal law merely in order to give the

Government an advantage over private parties in law suits is to malign the important function of this Court as balance wheel in our dual system of government. It may well be that in many cases the effect of applying federal law would be advantageous to the claims of the Government, but in other cases this would not be true.* In any event that factor is not the reason which impels this Court to apply federal rather than State law.

The considerations of public policy which indicate the desirability of uniformity in connection with a federal subject matter are very similar to the considerations which must be weighed by the Court in determining when uniformity is desirable in the familiar field of regulation of interstate commerce. *Southern Pacific Co.* v. *Arizona,* 325 U. S. 761, 767 (1945). In any event the need for uniformity must be shown to be beneficial to the general public interest, and not merely an administrative convenience to employees of the federal government.

Thus in *Davies Warehouse Co.* v. *Bowles,* 321 U. S. 144, 155 (1944), the Price Administrator argued that it would facilitate his administrative task to adopt a nationwide uniform definition of "public utilities," when Congress had provided none. But this Court held that such considera-

* As said in *U. S.* v. *Matthews,* 139 F. Supp. 683, 690 (N. D. Calif. N. D. 1956): "What is sauce for the federal plaintiff as gander ought to be sauce for it when it is the goose."

tions were not controlling, and that where a federal statute simply incorporated a general legal concept, the coverage of the terms used may be determined by State law in the particular case. Thus Congress may incorporate by reference the State law definitions of "real estate" (*R. F. C.* v. *Beaver County,* 328 U. S. 204, 209 (1946)), "children" (*De Sylva* v. *Ballentine,* 351 U. S. 570 (1956)), "heirs" (*Hutchinson Investment Co.* v. *Caldwell,* 152 U. S. 65, 68 (1894)), "next of kin" (*Poff* v. *Penna. R. R. Co.,* 327 U. S. 399, 401 (1946)), and similar terms.

The *Clearfield* case, involving government obligations in the form of commercial paper, is merely one exemplification of the underlying principle that federal law governs a federal subject matter requiring uniformity. The principle has been applied in numerous other fields of law by decisions of this Court.

Thus in the field of railway labor litigation it was held that a right based upon a duty imposed by a federal statute is a federal right, derived from federal legislation and the policy which it embodies. *Steele* v. *L. & N. R. R. Co.,* 323 U. S. 192, 204 (1944).

Another excellent illustration of the underlying principle upon which the *Clearfield* decision is based is afforded by *U. S.* v. *County of Allegheny,*

322 U. S. 177, 182-83 (1944). This Court there said:

> The purpose of the supremacy clause was to avoid the introduction of disparities, confusions and conflicts which would follow if the Government's general authority were subject to local controls. The validity and construction of contracts through which the United States is exercising its constitutional functions, their consequences on the rights and obligations of the parties, the titles or liens which they create or permit, all present questions of federal law not controlled by the law of any state (p. 183).

Bankruptcy law is another field where a uniform federal rule regulates the proof and allowance of claims and the distribution of assets. *Heiser* v. *Woodruff*, 327 U. S. 726, 732 (1946).

Francis v. *Southern Pacific Co.*, 333 U. S. 445 (1948), is another case which illustrates the basic principles applicable to the case at bar. It involved an action against an interstate carrier for wrongful death of a passenger who was traveling on a free pass. Under the State law of Utah there would have been liability. But this Court held that the matter of tort liability for wrongful death was one of the matters governed by federal law, to-wit the provisions of the Interstate Commerce Act regarding the issuance of free passes by interstate carriers, and that there was no room for

the application of the Erie doctrine (p. 449-50).

The *Francis* case completely disposes of petitioner's contention in the case at bar that State law must apply because the action in the case at bar is the ordinary tort action for conversion. The tort action for wrongful death in the *Francis* case was equally a State-created run-of-mine cause of action. But this Court held that the subject matter fell within a field governed by federal law.

In fact the unsoundness of petitioner's contention in this regard has been patent ever since the famous case of *Gibbons* v. *Ogden,* 9 Wheat. 1, 2, 217-21 (1824). The plaintiffs in that case sought to assert a State-created cause of action based upon interference with their ownership of property, namely a monopolistic franchise to operate certain boats in New York waters. But the defendants had a federal license authorizing navigation in those waters, and relied successfully upon the superior authority of their license as a defense. Similarly, in the case at bar, defendants are asserting as a defense to the State-created tort action for conversion a defense based upon federal law.

The object of the *Erie* doctrine is to produce the same decision in a federal court as would be reached in a State court. This purpose is not defeated in cases where federal law is applied because the case involves a federal subject matter. In such a case, the governing federal rule would

be applied even if the case arose in a State court. *K. C. S. Ry. Co.* v. *Van Zant,* 260 U. S. 459, 468 (1923); *Hannum* v. *Amsterdam Casualty Co.,* 330 Pa. 353 (1938); *Pope & Talbot* v. *Hawn,* 346 U. S. 406, 409-11 (1953); *Garrett* v. *Moore-McCormack Co.,* 317 U. S. 239, 245-49 (1942). In the *Clearfield* case, the same decision would have been reached if the suit had been brought in a State court (although as a matter of policy the United States seldom sues in a State court).

Procurement contracts furnish another extensive field for the application of a federally formulated law of contracts. *Priebe & Sons, Inc.* v. *U. S.,* 332 U. S. 407, 411 (1947); *U. S.* v. *Standard Rice Co.,* 323 U. S. 106, 111 (1944); *U. S.* v. *Ansonia Brass and Copper Co.,* 218 U. S. 452, 462 (1910). See also *Royal Indemnity Co.* v. *U. S.,* 313 U. S. 289, 296 (1941).

Public lands and Indian affairs form another important field of subject matter where federal law controls. *U. S.* v. *Fullard-Leo,* 331 U. S. 256, 269-70 (1947);* *Jackson County* v. *U. S.,* 308 U. S. 343, 350 (1939); *Carpenter* v. *Shaw,* 280 U. S. 363, 367 (1930); *Utah Power & Light Co.* v. *U. S.,* 243 U. S. 389, 403-405 (1917).

The federal banking system and insurance of bank deposits furnish a field of federal subject

* It should be noted that in this case the Court cited the *Clearfield* case. Obviously commercial paper is simply one species of a rule embracing various types of federal subject matter.

matter more closely akin to that involved in the case at bar. Here a leading case is *D'Oench, Duhme & Co.* v. *F. D. I. C.*, 315 U. S. 447, 456 (1942). In that case a broker who had sold defaulted bonds to a bank gave the bank a note to be carried rather than the defaulted bonds as an asset of the bank. The bank's receipt for the note stated "This note is given with the understanding that it will not be called for payment." The original note was signed in St. Louis, Mo., and delivered to the bank in Illinois. The evidence did not show where the renewal note was signed, though it was dated at Belleville, Illinois. These transactions occurred prior to passage of the legislation insuring bank deposits. The question was whether the Federal Deposit Insurance Corporation could collect on the notes or whether its rights were subject to the original understanding with the bank that the notes were never to be paid. This Court held that, as a matter of federal law, the legislation of Congress disclosed a federal policy that the F. D. I. C. should be protected against misrepresentations with respect to the status of the assets of insured banks (p. 457-59). The broker was responsible for the creation of the false status, and should be liable for its continuance after the deposit insurance legislation went into effect (p. 461).

Another leading case is *Deitrick* v. *Greaney*, 309 U. S. 190, 200-201 (1940). Here again this Court applied the principle that judicial determination

of the legal consequences which flow from acts regulated by federal legislation is a matter of federal and not State law. There a bank director gave a note to the bank which was substituted for certain stock illegally held by the bank. It was understood that the bank was to continue to own the stock and that the note would never be paid. The Court held that the provisions of the National Bank Act constituted a complete system which could not be defeated by the attempted maneuver: "It is the federal statute which condemns as unlawful respondent's acts. The extent and nature of the legal consequences of this condemnation, though left by the statute to judicial determination, are nevertheless to be derived from it and the federal policy which it has adopted."

A particularly enlightening exposition of the nature of the doctrine calling for application of federal law where a federal subject matter is involved was given in *U. S.* v. *Standard Oil Co.*, 332 U. S. 301 (1947). In that case a soldier had been injured as a result of the negligent operation of a motor vehicle by the defendant. Hospitalization expenses which would have been recoverable from the defendant by a civilian plaintiff were borne by the Government because the soldier's military status entitled him to such hospitalization privileges. The Government attempted to introduce an innovation in tort liability by bringing against the negligent defendant an action analogous to the husband's or father's

remedy for a wrong done to his wife or daughter *per quod servitium amisit.*

This Court declined to recognize the existence of such liability, but before reaching the topic of tort liability *vel non* concluded that that issue presented a question determinable as a matter of federal law and not State law. In that connection, the Court cited the *Clearfield* case, and emphasized that the principle underlying that case was not limited to determination of the rights and duties of the United States on commercial paper which it issues, as petitioner contends in the case at bar. The Court said: "Although the *Clearfield* case applied these principles to a situation involving contractual relations of the Government, they are equally applicable in the facts of this case where the relations affected are non-contractual or tortious in character." (p. 305). Discussing the federal character of the subject matter involved in the relationship between the soldier and his sovereign, the Court said "as the Federal Government has the exclusive power to establish and define the relationship by virtue of its military and other powers, equally clearly it has power in execution of the same functions to protect the relation once formed from harms inflicted by others" (p. 306). The hospitalization expenses also involved the Government's fiscal powers. "Indeed in this aspect, the case is not greatly different from the *Clearfield* case or from one involving the Government's paramount power of

control over its own property, both to prevent its unauthorized use or destruction and to secure indemnity for those injuries." (p. 306). The Court made plain that the *Erie* rule did not have the effect of "broadening State power over matters essentially of federal character" (p. 307).

The Court explained that in this area of federal common law the rules evolved by federal courts (and ultimately by this Court) represent "independent federal judicial decision" outside the constitutional realm. (p. 308). In such cases, whenever the federal courts have occasion to decide a federal question which cannot be answered from federal statutes alone, they must fashion a rule appropriate to give effect to the policy of governing legislation, and to this end may apply the traditional common-law technique of decision and draw upon all the source materials of the common law. *D'Oench, Duhme & Co.* v. *F. D. I. C.*, 315 U. S. 447, 469-72 (1942); *Deitrick* v. *Greaney*, 309 U. S. 190, 201 (1940).

The doctrine of federal law for the governance of federal subject matter, as exemplified in *Clearfield* and other cases discussed in this section of the brief, is not "the ghost of *Swift* v. *Tyson*" as petitioner contends, nor does it postulate "a brooding omnipresence in the sky." It is simply the application of ordinary common law judicial technique to the decision of questions which must ultimately be decided by this Court but which

are not governed by State law or by the specific terms of a federal statute.

Erie simply requires that when a federal court is functioning as a State court under diversity jurisdiction and is applying the common law of a State, it shall derive such law from the applicable State decisions, and not from the federal court's own ratiocinations. When the doctrine of federal law for governance of federal subject matter applies, as in the *Clearfield* case, the federal rule would be followed even if the case arose in a State court, because it springs from and inheres in the nature of the subject matter treated.

That recognition of an appropriate area for the operation of "federal common law" of the type of which we have been speaking is not incompatible with proper respect for the *Erie* doctrine is shown by the fact that *Hinderlider* v. *la Plata River and Cherry Creek Ditch Co.*, 308 U. S. 92, 110 (1938), was decided on the same day as *Erie*, and the opinion was likewise by Mr. Justice Brandeis. The *Hinderlider* case involved apportionment of the water flowing in an interstate stream. This subject matter was recognized by this Court as constituting another appropriate field in which federal law was held determinative, even though the decision involved the sacrifice of private property rights granted by the State law of Colorado.

In the light of the numerous decisions which

have been reviewed where the existence of an appropriate area for application of federal law has been recognized, it is difficult to perceive any justification for petitioner's scruples regarding the constitutionality of such recognition. It is equally impossible for petitioner to derive any comfort from the Conformity Act.* Far from being a "Congressional mandate" which bears upon the problems presented by the case at bar, that time-honored statutory provision simply directs that State law shall be applied where it is applicable. The issue in the case at bar is whether or not State law is applicable under the circumstances here involved, or whether federal law governs (as in *Clearfield* and the other cases discussed above). To cite the Conformity Act is simply question-begging avoidance of the crucial issue in controversy.

The foregoing decisions clearly demonstrate that in divers diversified fields in which the public interest calls for uniformity of treatment, this Court has recognized the doctrine of applicability of federal rather than State law in situations where a federal subject matter is involved.

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* "The laws of the several States, except where the Constitution or treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States, in cases where they apply." 28 U. S. C. 1652. This carries forward the substance of Section 34 of the Judiciary Act of September 24, 1789, 1 Stat. 92. In accordance with *Guaranty Trust Co.* v. *York*, 326 U. S. 99 (1945), equity suits are expressly included in the 1948 revision.

It is submitted that this principle should be applied in the case at bar. The entire process of transmitting government bonds through the Federal Reserve System in accordance with Treasury regulations for redemption should be governed by federal law. This is necessary in order to protect the government's vital interest in the federal financial structure. The type and variety of government securities to be issued is a matter for determination by the federal government. Maintaining the integrity of the structure so established is likewise clearly a matter of concern to the federal government.

Petitioner contends that it is difficult to believe that the salability of government securities will be substantially affected one way or the other by the rules applied to determine the rights and privileges of owners and transferees *inter sese.* In any event, petitioner asserts, the United States is concerned with the interest and attitude of the first purchaser of government bonds, rather than with the protection of parties subsequently dealing with them.

This argument overlooks the fact that much of the value of certain types of government bonds depends upon their free transferability and the willingness of subsequent parties to engage in dealings with respect to such bonds. The value of the bonds to the original purchaser is thus dependent upon the rules of law protecting subse-

quent parties who act in good faith in participating in transactions with respect to such bonds. If such parties may not safely engage in such transactions, the value of the bond to the first purchaser and its salability by the government is materially affected.

That purchasers desire readily transferable and negotiable bonds, and are willing to run the attendant risks in order to obtain the advantageous features desired, is shown by statistics with regard to the volume of bearer bonds outstanding in proportion to the volume of other types of securities. Purchasers desirous of the protection which petitioner would provide may now obtain protection by purchasing non-negotiable registered or non-transferable bonds. But when purchasers indicate a preference for negotiable bearer bonds, and the government by issuance of this type of security indicates the vital importance of that type of bond in the financial structure of the government, it is certainly essential that the integrity of such decisions be protected against interference by State law.

It has long been well settled law that the Treasury regulations having the force of law may validly attach to government obligations the status of non-transferability. *U. S.* v. *Janowitz*, 257 U. S. 42, 45 (1921); *U. S.* v. *Sacks*, 257 U. S. 37, 41 (1921); *U. S.* v. *Dauphin Deposit Trust Co.*, 50 F. Supp. 73, 75-77 (M. D. Pa. 1943); *Guldager* v. *U. S.*, 204 F. 2d 487, 489 (C. A. 6, 1953).

The government has the same power to prescribe that bonds shall be transferable as it has to prescribe that they shall not be. The integrity of the nation's fiscal system is involved to the same extent under either alternative and the government has the same vital interest in protecting the functioning of the type of financial structure which it has established.

Even the dissenting judges below concede that the nature of the obligation is so far controlled by federal law, that that law may govern the question of assignability. But they believe that State law determines whether a given transaction operates as an effective assignment (R. 505, 226 F. 2d 303).

But if the transactions of assignment were subject to State law, it is plain that the integrity of the federal government's decisions regarding its financial structure would be impaired. The States would be at liberty to frustrate and defeat entirely the negotiable status which the federal government sought to attach to this type of its obligations.

If Pennsylvania or any other State should come to think that thefts of government bonds were so numerous as to create a problem similar to that presented by stolen automobiles, such State would be perfectly free to provide that no government bearer bond within its jurisdiction could be transferred without endorsement of the names and ad-

dresses of the parties, and could also provide that before such a transaction of assignment should be valid a certificate must be obtained from the Secretary of the Commonwealth or the head of the State Police that no claim was on file that such bonds had been stolen. It is very plain that such a system of analogizing the sale of government bearer bonds to the sale of an automobile with the title registered in the State capital would completely frustrate the federal policy of protecting the readily negotiable quality of its bearer bonds.

Perhaps the most conclusive reason militating against the application of State law is one that was pointed out in the opinion of the Court below (R. 498, 226 F. 2d 299).

> The desirability of having uniformity of results in a determination of the rights of transferees of such bonds is just as important as having uniformity in a determination of the rights and liabilities of the United States, a party to the original obligation, so that the vast amounts of government bonds presently in circulation can be free of the myriad of doubts which would arise if the rights of the transferees must be determined by the several and diverse laws of the states, for then a purchaser of such bonds would, of necessity, in each case have to make inquiry as to the prior route taken by the bonds.

This disadvantage would be experienced whether or not the States undertook to pass restrictive legislation of the sort mentioned above. Simply as a matter of making certain what rights were created in transferees under the applicable State laws, it would be necessary for the purchaser of negotiable bonds to have a record of the prior transactions and of the places where they occurred. The need for preserving such a pedigree of the prior transfers and lineage of the bonds would in fact result in a complete transformation of the nature of the instruments themselves.

Instead of being freely negotiable bearer bonds they would in fact be instruments passing under endorsements, and the endorsements would have to show the time and place of each transaction. To require such an Odyssey describing the wayfarings of each of the myriad government bonds in circulation would inevitably paralyze the market for such securities and interfere with the discretion of the federal government to determine whether a particular issue of obligations should be negotiable bearer bonds or registered or nontransferable bonds.

In view of the foregoing reasons it is plain that there is a vital public interest in uniformity which requires the application of federal rather than State law with respect to the subject matter involved in the case at bar.

II

A "conduit" or intermediary in the process of transmitting Government bearer bonds for redemption in good faith and in strict accordance with Treasury Regulations is not liable for conversion of the bonds handled.

Assuming that federal law governs the process of transmitting government bearer bonds through the channels of the Federal Reserve System for redemption, we turn to the question: What are the liabilities of a bank or individual* acting as a "conduit" or intermediary in that process? Is such a party liable for conversion of bonds handled, in the absence of bad faith? Must such party have the status of "holder in due course" in order to be free from liability?

The trial court ruled that the "conduit" bank had the burden of proving its status as "holder

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* The positions of Parnell and the Bank in Indiana are identical insofar as their status as "conduit" or intermediary in the collection process is concerned. They are somewhat different with respect to the evidence as to good faith. The F. B. I. circular to banks in general was not admitted against Parnell, but might have been regarded as remote evidence of notice to the Bank. (R. 241, 244-49). But even so the Bank acted in good faith, under the holding in *Graham* v. *White-Phillips Co.*, 296 U. S. 27, 28-30 (1935), that inadvertent inattention after actual notice does not negate good faith. Against Parnell, but not the Bank, there was evidence given by Rocco to the effect that Parnell was paid more than $650 out of the proceeds of the bonds. But this payment, whatever the amount was, took place *after completion of the transaction with respect to the bonds*, and would be extremely remote evidence as to Parnell's good faith at the time of the transactions. A verdict should have been directed in favor of Parnell as well as the Bank.

in due course" of the bonds involved in the case. That concept includes, *inter alia,* proof of giving value. The trial judge said "Had they been purchased for investment, for this bank's portfolio, then I would have agreed with you" and would have granted a directed verdict in favor of the Bank (R. 402. See also R. 222, 228, 230, 235, 260, 264-65, 404-5, 420-22, 446).

We submit that the public interest requires that if a purchasing bank would be protected, a "conduit" bank should be protected *a fortiori.*

The Government's interest in salability of this type of bond and in ensuring free transferability thereof, as well as the usefulness and attractiveness of government bearer bonds to investors as a convenient method of holding highly liquid assets in a form which is the practical equivalent of cash,* would be seriously impaired by adoption of the rule advocated by the minority opinion of the Court of Appeals. That rule, as we have seen in Point I of this brief, would practically transform the nature of bearer obligations into instruments passing by endorsement or requiring a record of the past transfers of the bonds and the time and place where such transactions occurred. This would completely destroy the usefulness of government bearer bonds as a readily circulating

* Indeed much of our circulating currency consists of government obligations which are non-interest-bearing and are printed on small pieces of paper.

liquid medium of investment with flexibility practically equivalent to cash. Such annihilation of the distinctive features of bearer bonds in the hands of the purchasers would correspondingly frustrate and defeat the jurisdiction committed by Congress to the fiscal authorities of the Government to fashion the debt structure in accordance with a flexible and discretionary pattern. Bearer bonds, as we have known them in the past, would be eliminated from the picture. The Treasury would be limited to issuance of securities having the characteristic features of registered or non-transferable bonds.

It is unnecessary to elaborate upon the disastrous consequences of such a situation. On the other hand, the result reached by the majority of the Court of Appeals, in accordance with prior federal decisions, preserves and protects the vital interests both of the financial community and of the Government in maintaining the integrity of the essential characteristics of government bearer bonds.

Under federal law a "conduit" bank is liable only if bad faith is proven. The burden of proof that the bank had notice of any infirmity or irregularity in the transaction is placed upon the party seeking to hold the "conduit" bank liable. Federal law recognizes that if a purchaser bank is protected, a "conduit" bank must *a fortiori* be protected.

Any other rule would paralyze the banking system and clog the normal channels of commerce. It would be utterly irrational and impracticable to hold a bank which merely acts as an agency for the transmission of bonds and disbursement of the proceeds collected to a higher standard of care and diligence than is required of a bank which occupies the status of a prospective purchaser of such bonds for investment. Reason and logic dictate that the investor should be held to a stricter standard than the instrumentality of commercial intercourse. A contrary rule would be absurd and disastrous. A "conduit" bank is entitled to protection *a fortiori* in a situation where a purchasing bank would be protected. The trial judge's ruling was clearly wrong, and the decision of the Court of Appeals clearly correct.

That decision has the support of authority as well as of reason. The leading case cited in the Court's opinion (R. 499, 226 F. 2d at 300) is *Murray* v. *Lardner,* 2 Wall. 110 (1864). This Court there said:

> The general rule of the common law is, that, except by a sale in market overt, no one can give a better title to personal property than he has himself. The exception from this principle of securities, transferable by delivery, was established at an early period. It is founded upon principles of commercial policy, and is now as firmly fixed as the rule to which it is an exception. (p. 118).

The Court continued:

> *Suspicion of a defect of title or the knowledge of circumstances which would excite such suspicion in the mind of a prudent man, or gross negligence on the part of the taker, at the time of transfer, will not defeat his title. That result can be produced only by bad faith on his part.*
>
> *The burden of proof lies on the person who assails the right claimed by the party in possession.*
>
> Such is the settled law of this court, and we feel no disposition to depart from it. (p. 121, italics supplied).

The securities stolen from Lardner's home and sold through Murray, a reputable New York broker, were railroad bonds, payable to bearer. The decision would apply *a fortiori* in the case of government bearer bonds, because of the greater safety of the government bonds, which, as stated before, furnish a medium equivalent to cash in convenience as an investment for liquid capital. The "commercial policy" in maintaining free negotiability would be all the stronger in the case of government obligations.

The rule of *Murray* v. *Lardner* was reaffirmed in a famous case involving government bonds, *Texas* v. *White,* 7 Wall. 700, 735 (1868).* *Murray*

* The Court held, however, that the rule was inapplicable since the bonds in that case were taken after maturity. This question, insofar as it is of concern in the case at bar, will be treated in Point III of this brief. We contend that the transactions here involved took place before maturity of the bonds handled.

v. *Lardner* has never been overruled, but has often been followed.* It was cited as late as 1935.**

Important State courts have also accorded protection to "conduit" parties who act in good faith. In Massachusetts, *Pratt* v. *Higginson,* 230 Mass. 256 (1918), so held in a case involving government and public utility bonds. In New York, the highest court of that State, on which Chief Judge (later Mr. Justice) Cardozo and other eminent judges then sat, spoke to the same effect in *Gruntal* v. *U. S. F. & G. Co.,* 254 N. Y. 468 (1930). The same result was reached by the Supreme Court of Pennsylvania in *First National Bank* v. *Goldberg,* 340 Pa. 337, 341-42 (1941). The Restatement, Agency, sec. 349, comment g, and Torts, sec. 233, subsection 4 take the same view; and apparently the only case to the contrary is *Kimball* v. *Billings,* 55 Me. 147, 152 (1867), but there the agent who sold the bonds still held the proceeds (pp. 149-50; *Smith* v. *Harlow,* 64 Me. 510, 516-17 (1874)). It is obvious that the federal and State cases relieving "conduit" parties who act in good

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* Among the cases where *Murray* v. *Lardner* was followed are *Hotchkiss* v. *Banks,* 88 U. S. 354, 359 (1874); *Ry. Co.* v. *Sprague,* 103 U. S. 756, 760 (1880); *Morgan* v. *U. S.,* 113 U. S. 476, 491 (1885); *Kneeland* v. *Lawrence,* 140 U. S. 209, 212 *(1891); County of Presidio* v. *Noel-Young Co.,* 212 U. S. 58, 70 (1909).

** *Graham* v. *White-Phillips Co.,* 296 U. S. 27, 32 (1935).

faith are sound in principle and should be followed.*

Restatement, Agency, Comment g to sec. 349 states:

> The agent may be protected although his principal is not privileged. Thus, if an agent sells, on account of his principal a negotiable instrument, the holder of which has the power to pass title, the agent does not commit conversion if he sells such instrument without notice of the rights of the person entitled to possession, although his principal is not a bona fide holder of the instrument.

Restatement, Torts, sec. 233 (4) reads:

> The statement in subsection (1) [conversion of chattel by agent] is not applicable to an agent or servant who disposes of current money or a document negotiable by

* It may be of significance that a conservative authority on conversion favors exemption from liability for conversion of common carriers and warehousemen who act as a "mere conduit pipe" in connection with *chattels other than negotiable instruments.* Edward Henry Warren, *Trover and Conversion* (1936) 90-92. "It is one thing to require a cotton broker to determine at his peril whether he is buying from a person authorized to sell. It is a very different thing to require a person employed only to store or transport to determine at his peril whether the goods have been properly brought to him." By parity of reasoning, and *a fortiori*, in the case of bearer bonds a "conduit" bank which merely handles the bonds for redemption and disburses the proceeds collected should be relieved from liability for conversion in a situation where a bank purchasing the bonds for investment would be protected.

> common law or by statute pursuant to a transaction by which the transferee becomes a holder in due course of such money or document, unless the agent or servant knows or has reason to know that his principal or master does not have authority so to dispose thereof.

These statements indicate a policy in favor of protecting a "conduit" party, although the terminology of "holder in due course" is employed, which is not properly applicable in a "conduit" situation. It is out of place to refer to "holders" and "negotiation" when the process is actually one of "presentation" to the obligor for payment. Britton on Bills and Notes (1943) 1035: "Instruments are 'negotiated' to purchasers . . . Instruments are not usually negotiated to principal debtors and other payors but are 'delivered up,' or 'surrendered' to the payor."

Parnell at no time negotiated in any manner the bonds here involved, nor was there any negotiation on the part of the Bank of Indiana. They simply forwarded the bonds for collection through the channels prescribed by Treasury Regulations. They gave no value when they took the bonds, and parted with no value other than the proceeds collected when they disbursed such proceeds. It is awkward and artificial to apply the categories and concepts of the Negotiable Instruments Law to such a "conduit" situation, as Judge Goodrich

tries to do in his dissenting opinion. Disregarding such semantic concepts, this Court should apply as the appropriate federal rule suitable to the situation the established principle protecting such "conduit" or intermediary parties in the collection process from liability for conversion.*

The Congress, and the Secretary of the Treasury through regulations having the force of law, have determined that these bonds should be issued in bearer form and that they should be transferable by delivery. The legal consequence of such determination is not merely that the bonds may be discharged by payment to the person presenting them (indeed that subject is separately covered elsewhere in the Regulations) but also that in transactions in the market place between other parties *inter sese* the bonds may safely be dealt

* The awkwardness and artificiality exhibited by the attempt of the minority below to adjudicate the status of "conduit" parties in terms of the Procrustean categories of the N. I. L., instead of applying a just and rational rule fashioned in accordance with the traditional judicial technique of the common law to fit the actual facts and felt needs of the situation involved, illustrates the wisdom of the observations made in 1870 by Mr. Justice Holmes on "Codes, and the Arrangement of the Law." Because of the inevitable inflexibility and fortuitousness of statutes, they serve as a sorry substitute for the uncrystallized juices of life which must animate the judicial process if justice is to be rightly administered. "If the code is truly law, the court is confined to verbal construction . . . and must decide the case wrong." Harry C. Shriver, *Justice Oliver Wendell Holmes: His Book Notices and Uncollected Papers* (1936) 61-64. Similarly, if the N. I. L. is to be accepted as truly authoritative in the case at bar, the judicial function will be limited to the type of mechanical manipulation of verbal tokens which the minority opinion displays, and will necessarily culminate in a result which is wrong.

with as bearer securities which can be transferred freely like currency or negotiable instruments; and hence that a "conduit" bank serving as intermediary in the collection process is relieved of liability for conversion.

Accordingly, we submit that the "conduit" parties in the case at bar are entitled to the protection of the federal law as above set forth. Reason and precedent concur in this conclusion.

III

Government bonds, redeemable but not yet due and payable, are not overdue paper.

The bonds involved in the case at bar showed on their face that they were payable May 1, 1952, and that the right was reserved to call them on any interest date on or after May 1, 1944 (R. 449). They were in fact called on May 1, 1944. The Bank in Indiana had knowledge of the call, but Parnell did not, at the time of the transactions involved (R. 355, 312-13).

By the terms of the bonds, interest was discontinued after the call date (R. 450). When the bonds were forwarded by Parnell and the Bank to the Federal Reserve Bank of Cleveland, inoperative interest coupons for the period subsequent to May 1, 1944, were attached to the bonds

(R. 355). This was required by Treasury Regulations.*

Did the presence of these inoperative interest coupons make the bonds overdue paper, and deprive the "conduit" parties of the protection they would otherwise have received under the federal law as set forth in Point II of this Brief, *supra?*

It will be recalled that in *Texas* v. *White,* 7 Wall. 700, 735 (1868), the Court treated the bonds there in suit as overdue after December 31, 1864, the date when they were "redeemable," and the date of the last interest coupon attached. The holders of those bonds purchased them as a speculation for a few cents on the dollar. The circumstances surrounding those particular bonds were highly unusual and *sui generis.* They were issued in settlement of a boundary dispute with Texas. That State passed a law requiring the Governor's signature before they could be transferred from the State treasury. During the Civil War, Texas repealed that law, in order to facilitate the transfer of some of the bonds to one White and one Chiles in order to further the Confederate cause by purchasing supplies. Apparently no supplies were obtained, and after the war the "reconstructed" State of Texas asserted its title to the bonds in suit, claiming they were part of the batch delivered to White and Chiles. The climate of

* Treasury Department Circular No. 666, section 307.6. 31 C. F. R. 307.6. See Appendix, *infra.*

Reconstruction sentiment undoubtedly made the Court astute to find grounds for upholding the State's title rather than that of the speculators who sought to aid the Confederate cause.*

But even the language used in *Texas* v. *White* recognizes the distinction between the date when a bond is "payable" and when it is "redeemable" if that distinction is expressed on the face of the bond.** The bonds in *Texas* v. *White* did not express such a distinction; the fact that the interest coupons extended only to December 31, 1864, indicates that "redeemable" was used in the sense of "payable."

But even under *Texas* v. *White* the bonds involved in the case at bar would not have been overdue. The distinction was expressed on the face of the bonds, and interest coupons were attached continuing beyond the date when the bonds became redeemable on call up until the final date when the bonds became due and payable.

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* Several rather questionable rulings were made in *Texas* v. *White*, doubtless due to wartime sentiment. Thus it was held that the first Texas law restricting alienation of the bonds was valid, but that the repealing act was not, being in aid of rebellion, and that White and Chiles got no title to the bonds. (This was overruled in *Morgan* v. *U. S.*, 113 U. S. 476, 494-96 (1895)). The Court was apparently unwilling to treat the Texas legislation and public notoriety regarding the bonds as sufficient proof of notice to the purchasers, but found that the bonds were overdue when purchased.

** 7 Wall. at 735. On this point see also *Morgan* v. *U. S.*, 113 U. S. 476, 497 (1885).

In any event, the questionable holding in *Texas* v. *White* that "redeemable" was there equivalent to "payable," was qualified in *Vermilye Co.* v. *Adams Express Co.*, 21 Wall. 138, 145 (1874).*

But a leading case where the decision is squarely in point was subsequently handed down by this Court. *Morgan* v. *U. S.*, 113 U. S. 476, 497-501 (1885).

In the *Morgan* case the bonds were redeemable on July 1, 1870, and payable on July 1, 1885 (p. 479). Under the terms of the Act of July 14, 1870, 16 Stat. 272, they were exchangeable for new bonds to be issued under that Act at a lower interest rate (p. 480, 503-4). On July 30, 1878, October 31, 1878, and March 18, 1879, calls for redemption were made (p. 482). During 1879 a syndicate including J. P. Morgan and other prominent bankers bought in London, from respectable parties, bonds which had been called, and they knew of the call. They did not know that some of the bonds purchased had been stolen on October 27, 1878, from the Manhattan Savings Bank. (pp. 481-83). Many millions of these bonds were dealt in on the London market after the call (p. 485).

The Court held that the bonds did not become

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* There the stolen notes were expressly made payable on July 15, 1868. The fact that they were convertible into other securities did not qualify the definiteness of the due date.

overdue until after the date when they were *due and payable* (p. 501). They did not become overdue upon the date of the call, when they became *redeemable.*

Called government bonds, the Court points out, do not become dishonored or *functus officio* upon being called. They merely cease to bear interest. A holder to whom interest is not the prime consideration may properly retain his bonds until the due date because of their utility and value as a safe and convenient repository of liquid capital, circulating almost as freely as money (p. 500).

In the *Morgan* case the Court emphasized that call for redemption effected no change in the original rights of the holder except the loss of interest. The bond is "not overdue, in the commercial sense, till after the day of unconditional payment . . . it seems to us quite plain that it could not be considered an overdue obligation, in the sense in which that term is applied to ordinary commercial paper, until after the time limit fixed for final payment had passed." (p. 499).

The Court continued:

> The title of the purchaser of overdue negotiable paper, such as a bill of exchange or a promissory note, stands on the same footing as if it had been dishonored by a refusal to accept or pay, and had been put under protest. When transferred after it has become due, although not reduced to

the rank of an ordinary chose in action, the legal title to which cannot pass by assignment or delivery, it carries on its face the presumption which discredits it, and deprives it of that immunity which, while the time for payment was still running, was secured to it in favor of a bona fide purchaser for value without actual notice of any defect, either in the obligation or the title. This was put by Mr. Justice Butler, in *Brown* v. *Davies,* 3 T. R. 80, on the ground that to take an overdue note or bill was "out of the common course of dealing." Ordinarily a note or bill when due becomes *functus officio,* because it was made to be paid at maturity, and if it fails of its intended operation and effect, the presumption is that it is owing to some defect, which has furnished a sufficient reason to the party apparently chargeable for not having punctually performed his obligation. In the strong language of Lord Ellenborough in *Tinson* v. *Francis,* 1 Camp. 19, "after a bill or note is due it comes disgraced to the indorsee."

No such presumption, in our opinion, arises to affect the title of a holder of the bonds of the United States, such as those now in question, acquired by a bona fide purchaser for value prior to the date fixed in the bonds themselves for their ultimate payment; for, as we have already shown, the only change in the original effect of the contract by the exercise of the right of earlier redemption is to stop the obligation to pay future interest. And as against one

> choosing for any purpose of his own to retain his bond as a continuing security for the value it always represents, having impressed upon it by the law of its creation the faculty of passing from hand to hand as money, and therefore just as useful in the pursuits of trade and the exchanges of commerce and banking as so much money in the form of coin or bank notes, and more convenient because more portable, no such presumption can be entertained on the ground that its continued circulation is not in the due course of business, that it has fully performed all its intended functions, and that it has been in any sense dishonored by a refusal on the part of the obligor to fulfil its obligation. On the contrary, supposing the purchaser bound to know, what in fact does not appear on its face, that the bond has been called for redemption under penalty of a stoppage of interest after three months, the very notice, which, it is said, discredits his title, is in fact an advertisement, not that the maker has any ground to refuse payment, but that the previous holder preferred to hold the security for the money rather than to accept the money which it represents. (pp. 499-501).

The *Morgan* case has never been questioned, nor is it diluted by the passage which petitioner quotes from Mr. Justice Cardozo's opinion in *Smyth* v. *U. S.*, 302 U. S. 329, 353 (1937):

> The so-called redemption provisions of

> the bonds are provisions for the acceleration of maturity at the pleasure of the Government, and upon publication of the notice of call for the period stated in the bonds the new date became substituted for the old one as if there from the beginning.

This was merely a colorful and emphatic way of stating that interest should cease upon the date specified in the call.* The question in the *Smyth* case, as stated by Mr. Justice Cardozo's opinion, was:

> Was a notice of call issued by the Secretary of the Treasury for the redemption of Liberty Loan bonds effective to terminate the interest on the bonds from the designated redemption date? (pp. 348-49).

The plaintiff in that case had brought suit upon an interest coupon bearing date *subsequent to the redemption date* specified in the call (p. 351).

The real point in controversy was whether the bonds were payable in gold, as called for by their terms, or in such currency as was legal tender at the date of redemption (p. 358).

The bondholders' theory was that the subsequent interest coupons were valid because the re-

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* There is no conflict in substance, as petitioner contends, between this language and what is said in *Morgan* v. *U. S.* at 113 U. S. 498.

demption notice was ineffective; the notice was ineffective because it was fraudulent or illusory as the Government did not intend to pay *in gold as called for by the bond* on the redemption date. (p. 354).

As stated by the dissenting Justices:

> The right to redeem and pay the bonds at face value after notice was reserved—nothing else. Did the United States give notice of a bona fide purpose so to redeem and pay? If not they cannot properly claim to have exercised their option to mature the obligation. That they did not honestly comply with this necessary preliminary becomes obvious upon consideration of the circumstances and pertinent legislation. . . . The Government simply has not in good faith complied with a condition precedent. It has never given notice of purpose to pay the obligation according to its terms. Its suggestion was to make payment of another kind. (p. 366).

As the Court of Appeals says (R. 502, 226 F. 2d 301), "Smyth was not concerned with the Morgan problem and nowhere is Morgan referred to in the Smyth opinion."

Mr. Justice Cardozo does state that the bondholders "were not under a duty to do anything at all at the accelerated maturity, though they

were privileged, if they pleased, to present the bonds for payment." (p. 357).

This is in accord with the *Morgan* holding that the holders "had a right, without prejudice, except as to loss of interest, to wait without demand for the whole period, at the expiration of which the bond was unconditionally payable." (113 U. S. at 501).

If parties dealing with the bonds involved in the case at bar could thus properly regard them as not being overdue until May 1, 1952, the date upon which they were payable, (rather than the earlier date of May 1, 1944, when they became redeemable), did the presence of inoperative interest coupons change the situation or constitute any sort of constructive notice of irregularity?

Here, too, the law is clear that the interest coupon is an independent bearer instrument separate from the bond, and that the presence of overdue* interest coupons does not constitute notice of any

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* It should be noted that the coupons attached to the bonds here involved were not *overdue*, but merely *inoperative*, because they became void after the call. The Government was not in default, because it did not owe any duty to pay with respect to such inoperative coupons. Chafee, "Rights in Overdue Paper," 31 Harv. L. R. 1104, 1126 (1918), advocates the view that equities of ownership, as distinguished from equities of liability, should not be recognized to the detriment of bona fide takers of overdue paper. On this analysis, petitioner's claim here would be an equity of ownership. The Government's known solvency would preclude any equity of liability.

infirmity with respect to the principal amount of the bond to which they were attached. *Ry. Co.* v. *Sprague,* 103 U. S. 756, 760-61 (1880); *County of Presidio* v. *Noel-Young Bond & Stock Co.,* 212 U. S. 58, 74-75 (1909).

Accordingly, if this Court accepts our contentions in Points I and II *supra* with regard to the applicability of federal law and the non-liability of "conduit" parties for conversion, the presence of inoperative coupons upon the bonds covering the period between the date upon which they were redeemable and the date upon which they were payable would not require modification of the conclusions reached. Knowledge of the call on the part of the Bank in Indiana would not constitute notice of any irregularities or bad faith; and Parnell did not know that the bonds had been called.

CONCLUSION

The process of transmitting government bonds through the Federal Reserve system for payment, we submit, is governed by federal law. The *Erie* rule does not apply in the case at bar, but rather the doctrine that federal law governs federal subject matter where uniformity is desirable. That doctrine extends to a number of fields, and was applied to government obligations in the *Clearfield* case. *Clearfield* is not an exceptional or undesirable holding which should be restricted to

its own particular facts and limited to situations where the United States is a party litigant. The case at bar presents a situation where uniformity is desirable in the public interest. Both the welfare of the financial community and the Government's discretionary power with respect to the public debt structure require maintenance of the integrity of the distinctive characteristics of government bearer bonds. These would be obliterated, and such obligations would in practice be transformed into registered or non-transferable securities if a rule requiring application of State law and a record of the bonds' Odyssey were to be accepted by this Court.

A "conduit" bank, serving only as an intermediary in the collection process and forwarding government bearer bonds in strict accordance with Treasury Regulations for redemption, can not in the absence of proof of bad faith be held liable for conversion of the bonds handled.

It would be unjust, impracticable, illogical, and would paralyze the channels of banking and commerce for this Court to require of "conduit" banks a standard of care higher than that required of banks purchasing government bearer bonds as an investment. Where, as in the case at bar, a bank purchasing the bonds for investment would admittedly be relieved from liability for conversion, we earnestly submit that a "conduit" bank should be protected *a fortiori*.

The fact that the bonds involved in the case at bar had been called for redemption and that inoperative coupons were attached thereto at the time they were transmitted does not diminish the protection from liability for conversion to which these "conduit" parties are entitled.

The judgments of the Court of Appeals for the Third Circuit should be affirmed.

Respectfully submitted,

EDWARD DUMBAULD,
Attorney for Respondent.

SEPTEMBER 1956.

APPENDIX

The Home Owners' Loan Act of June 13, 1933, 48 Stat. 129, as amended by Act of April 27, 1934, 12 U. S. C. 1463 (c), provides in pertinent part: [Italics supplied.]

In order to provide for applications filed before May 28, 1935, for applications filed within thirty days thereafter, and for carrying out the other purposes of this section, the Corporation is authorized to issue bonds in an aggregate amount not to exceed $4,750,000,000, which may be exchanged as hereinafter provided, or which may be sold by the Corporation to obtain funds for carrying out the purposes of this section or for the redemption of any of its outstanding bonds; and the Corporation is further authorized to inincrease its total bond issue for the purpose of retiring its outstanding bonds by an amount equal to the amount of the bonds to be so retired (except bonds retired from payments of principal on loans), such retirement to be at maturity or by call or purchase or exchange or any method prescribed by the Board with the approval of the Secretary of the Treasury: *Provided,* That no bonds issued under this subsection, as amended, shall have a maturity date later than 1952. *Such bonds shall be in such forms and denominations, shall mature within such periods of not more than eighteen years from the date of their issue, shall bear such rates of interest not exceeding 4 per*

centum per annum, shall be subject to such terms and conditions, and shall be issued in such manner and sold at such prices, as may be prescribed by the Corporation, with the approval of the Secretary of the Treasury. Such bonds shall be fully and unconditionally guaranteed both as to interest and principal by the United States, and such guaranty shall be expressed on the face thereof, and such bonds shall be lawful investments, and may be accepted as security, for all fiduciary, trust, and public funds, the investment or deposit of which shall be under the authority or control of the United States or any officer or officers thereof. In the event that the Corporation shall be unable to pay upon demand, when due, the principal of, or interest on, such bonds, the Secretary of the Treasury shall pay to the holder the amount thereof which is hereby authorized to be appropriated, and thereupon to the extent of the amount so paid the Secretary of the Treasury shall succeed to all the rights of the holders of such bonds. The Secretary of the Treasury, in his discretion, is authorized to purchase any bonds of the Corporation issued under this subsection which are guaranteed as to interest and principal, and for such purpose the Secretary of the Treasury is authorized to use as a public-debt transaction the proceeds from the sale of any securities hereafter issued under sections 752, 753, and 757 of Title 31, and the purposes for which securities may be issued under such sections are extended to include any purchases of the Corporation's bonds hereunder. The

Secretary of the Treasury may, at any time, sell any of the bonds of the Corporation acquired by him under this subsection. *All redemptions, purchases, and sales by the Secretary of the Treasury of the bonds of the Corporation shall be treated as public-debt transactions of the United States.* The bonds issued by the Corporation under this subsection shall be exempt, both as to principal and interest, from all taxation (except surtaxes, estate, inheritance, and gift taxes) now or hereafter imposed by the United States or any District, Territory, dependency, or possession thereof, or by any State, county, municipality, or local taxing authority. . . .

TREASURY REGULATIONS

31 Code of Federal Regulations (1949 edition):

306.3. *Coupon bonds and notes.* United States coupon bonds and notes are payable to bearer, and title thereto passes by delivery, without indorsement and without notice to the Treasury Department. . . .

306.24. *Redemption of bonds and notes; definition.* The term "payment" as ordinarily used by the Treasury Department applies to the payment of United States bonds and notes at maturity, while the term "redemption" is ordinarily used to cover payment before maturity pursuant to a call for redemption in accordance with the

terms of the bonds or notes. For the purposes of this part, however, the terms are used interchangeably, and no distinction need be drawn between them.

306.25. *Redemption of bonds and notes; interest stops.* Bonds and notes will cease to bear interest on the date of their maturity, unless called for earlier redemption in accordance with their terms, in which event interest ceases on the date fixed for redemption.

306.26. *Redemption of bonds and notes; coupon bonds and notes.* United States bonds and notes in coupon form are payable to bearer, and accordingly payment will be made in due course to the person surrendering them for redemption. Coupon bonds or notes which have become due and payable, whether on maturity or by virtue of a call for redemption, should be presented and surrendered to the Treasurer of the United States in Washington, or to any Federal Reserve bank or branch thereof, at the expense and risk of the holder; and should be accompanied by appropriate written advice. All interest coupons due and payable on or before the date of redemption should be detached from the bonds or notes and collected in ordinary course. Coupon bonds or notes called for redemption prior to maturity should, when surrendered, have all coupons attached which mature subsequent to the date of redemption. If any such subsequently maturing coupons are not so at-

tached, the bonds or notes will nevertheless be redeemed, but the full face amount of any missing coupons will be deducted. The amounts so deducted will be held in the Treasury to provide for the redemption of such missing coupons as may subsequently be presented.

306.79. *Coupon bonds or notes lost or stolen.* (a) The Treasury Department can grant no relief on account of lost or stolen coupon bonds or notes. United States bonds and notes in coupon form are payable to bearer, and title thereto passes by delivery, without indorsement, and without notice to the Treasury Department. Under generally recognized principles of law an innocent purchaser for value without notice before maturity acquires good title to coupon bonds or notes even though reported lost or stolen, and no proof of ownership is required when coupon bonds or notes are presented in regular course to the Treasury Department, or its designated agencies, for payment, exchange, or conversion. The Treasury Department assumes no responsibility whatever with respect to coupon bonds or notes reported lost or stolen and enters no stoppages or caveats against their payment, exchange, or conversion. This is the long-established policy of the Treasury, and is in accordance with the following public announcement made by the Secretary of the Treasury on April 27, 1867, and reaffirmed and republished from time to time as to United States

bonds and notes in coupon form reported lost or stolen:

In consequence of the increasing trouble, wholly without practical benefit, arising from notices which are constantly received at the Department respecting the loss of coupon bonds, which are payable to bearer, and of Treasury notes issued and remaining in blank at the time of loss, it becomes necessary to give this public notice, that the Government can not protect, and will not undertake to protect, the owners of such bonds and notes against the consequences of their own fault or misfortune.

Hereafter all bonds, notes, and coupons, payable to bearer, and Treasury notes issued and remaining in blank, will be paid to the party presenting them in pursuance of the regulations of the Department, in the course of regular business; and no attention will be paid to caveats which may be filed for the purpose of preventing such payment.

(b) The Treasury Department does not undertake to furnish any information with respect to the presentation of coupon bonds or notes reported lost or stolen, but it will, wherever possible, in order to assist in tracing lost or stolen securities, furnish, upon appropriate written inquiry, such information as may be available in the Department as to whether or not bonds or notes reported lost or stolen have already been presented, and, if already presented, as to the

source from which they were received. United States coupon bonds and notes are customarily handled in the regular course of business without reference to serial number, and in most cases, therefore, it is improbable that any information will be available as to the source from which received.

307.1. *Definitions—*

(b) *Payment.* As ordinarily used by the Treasury Department, the term "payment" refers to the payment of securities at maturity, while the term "redemption" refers to payment before maturity pursuant to a call for redemption in accordance with the terms of the securities. For the purpose of the regulations in this part, however, the terms are interchangeable, and the term "redemption" may refer to the discharge of a security by payment either at maturity, or before maturity pursuant to a call for redemption.

307.6. *Missing coupons.* If any coupons bearing dates subsequent to the redemption date of the securities are missing from bearer securities presented for redemption, the securities nevertheless will be redeemed, but the full face amount of any such missing coupons will be deducted from the payment to be made on account of such redemption, and any amounts so deducted will be held in the Treasury to provide for adjustments or refunds on account of such missing coupons as

may subsequently be presented: *Provided, however,* That if it is proved to the satisfaction of the Secretary of the Treasury that any such missing coupons (bearing dates after the redemption date) have been in fact destroyed the amount of such destroyed coupons will not be deducted from the payment on account of redemption, but in any such case the Secretary of the Treasury may require a bond of indemnity or a guarantee by an incorporated bank or trust company.